EUROPEAN CENTRAL BANK

President Jean-Claude Trichet closes the door on the need to raise interest rates further in the near future

ACCORDING TO THE EUROPEAN CENTRAL BANK (ECB)

• The key ECB interest rates was increased by 25 basis points, to 4.25%.
• HICP inflation rates have continued to rise significantly since the autumn of last year and they are expected to remain well above the level consistent with price stability for a more protracted period than previously thought.
• Risks to price stability at the policy-relevant medium-term horizon remain clearly on the upside and have increased further over the past few months. These risks include notably the possibility of further increases in energy and food prices.
• The uncertainty surrounding this outlook for economic activity remains high, owing not least to the very high levels of commodity prices, and downside risks prevail.
• The monetary policy stance will contribute to achieving our objective.

COMMENTS

As forecast, the ECB raised its key rate to 4.25% this morning. Anything else would have been a surprise as, in June, President Trichet had announced that a rate hike was very likely in July. With inflation estimated to be 4% in June, two percentage points above the ECB’s target, the Bank was certainly not going to waste the opportunity to ensure its credibility as a defender of price stability.

The 25 basis point hike ordered in July will not have much impact on total inflation, which stems mainly from the increase in energy prices set by world markets. However, because of ongoing high oil prices, the deterioration in the inflation outlook and increase in inflation expectations, the ECB is concerned about second-round effects associated with wage and price setting.

July’s increase should not be one of a series of interest rate increases. According to the ECB, interest rates are appropriate, and the fact that the words ”heightened alertness” have been dropped from the statement goes some ways toward indicating that the ECB would like to keep its rates steady.

Implications: The economic situation in PIGS (Portugal, Italy, Greece and Spain) is already fragile, and higher rates would only increase the likelihood of a generalized euro zone slowdown. That said, although we expect oil prices to correct, high inflation should keep the ECB from beginning a monetary easing cycle before 2009.

Martin Lefebvre
Senior Economist
On the basis of our regular economic and monetary analyses, we decided at today’s meeting to increase the key ECB interest rates by 25 basis points. This decision was taken to prevent broadly based second-round effects and to counteract the increasing upside risks to price stability over the medium term. HICP inflation rates have continued to rise significantly since the autumn of last year. They are expected to remain well above the level consistent with price stability for a more protracted period than previously thought. Moreover, continued very vigorous money and credit growth and the absence thus far of significant constraints on bank loan supply in a context of ongoing financial market tensions confirm our assessment of upside risks to price stability over the medium term. At the same time, while the latest data confirm the expected weakening of real GDP growth in mid-2008 after exceptionally strong growth in the first quarter, the economic fundamentals of the euro area are sound. Against this background and in full accordance with our mandate, we emphasise that maintaining price stability in the medium term is our primary objective and that it is our strong determination to keep medium and long-term inflation expectations firmly anchored in line with price stability. This will preserve purchasing power in the medium term and continue to support sustainable growth and employment in the euro area. On the basis of our current assessment, the monetary policy stance following today’s decision will contribute to achieving our objective. We will continue to monitor very closely all developments over the period ahead. [...]